Testimony of:
Joshua Green, General Partner
Mohr Davidow Ventures

Hearing on
The Importance of Technology in an
Economic Recovery
April 22, 2009

Committee on Small Business
US House of Representatives

Introduction

Chairwoman Velazquez, Ranking Member Graves, and members of the Committee, my name is Josh Green and I am a partner at Mohr Davidow Ventures (MDV), a venture capital firm in Menlo Park, California. I am also a member of the National Venture Capital Association based in Arlington, Virginia. My views today represent 460 member firms which currently comprise approximately 90 percent of all the venture capital under management in the United States.

Mohr Davidow invests in entrepreneurs creating businesses that address significant challenges and opportunities associated with the digital world, personalized medicine, and alternative energy. We have been in business for more than 25 years during which time we have taken a hands-on approach to architect and help build hundreds of start-up companies from the ground up. We work best with entrepreneurs who welcome our involvement as well as our venture capital funding. Once invested we typically take a seat on a company’s Board of Directors and we pride ourselves in rolling up our sleeves and diving in — whether it's collaborating on product and marketing strategies, developing smooth operations, establishing effective distribution strategies, attracting and retaining superior employees, or fine-tuning business models. For this reason we limit the number of venture capital investments we make so that each company gets the attention it needs and deserves.

I personally invest in the clean technology sector and am focused on creating businesses that offer economic value in the form of jobs and revenues and also promise to reduce our country’s dependence on foreign oil and help preserve our environment. Cleantech is the fastest growing sector of venture investment.

I would like to thank the Committee for the opportunity to share with you today the challenges that our small, venture-backed businesses have faced under past restrictions related to Small Business Innovative Research (SBIR) grants and why these grants are critical to the ongoing vitality of innovation and job creation in the United States. As an industry, we strongly support the re-authorization of the SBIR grant program, particularly if past inequalities are corrected so that all small businesses can compete for these critical funding grants. At a time when our country needs to build new businesses, the venture capital industry is committed to working with the government to bring a steady stream of innovation and economic value to market. We thank the Committee for your past attention to our concerns and are hopeful that the re-authorization will at long last provide a level playing field so that we can move forward together in supporting our country's most promising products and businesses.

Venture Capital Investment Overview

I would like to briefly explain how the venture capital industry creates and grows small businesses. Typically a venture capital firm is a small business itself, often with fewer than 25 employees. MDV, for example has just 9 full time investing professionals. We raise our funds of money by contributing our own capital while also seeking resources from institutional investors such as University endowments, foundations, and pension funds with the charter to invest those funds in promising young start-up businesses. Once a fund is raised, my partners and I look for the best and brightest entrepreneurs in which to invest, usually within a specific industry sector in which we have an expertise. Venture capitalists most often look for companies that are developing disruptive innovations and have the potential to grow from small businesses into large enterprises. For this reason, we are often investing in high technology areas such as IT, life sciences, and clean technologies. Over 40% of our entrepreneurs are scientists or engineers to whom we reach out at university and government labs, to whom we are introduced through others who are already in our network, or with whom we have worked in the past on building successful businesses.

Venture capitalists are focused on commercializing *applied* research. In order to be considered for venture capital investment, the entrepreneur typically has a product or service that has gone through the discovery process and is ready to be clinically tested and commercialized. If we believe the product has commercial promise, we will make an initial investment and look for the company to achieve certain milestones before we offer follow-on funding. We stay invested in these companies —both financially and through the sweat equity we offer — for anywhere from 7-10 years, often longer and rarely less. The ultimate goal is to build the business until it can go public or become acquired, generating a return for all employee shareholders and investors. In 2008, the venture capital industry invested more than $28 billion into over 3800 start-up companies in the United States.

Venture-backed Companies Drive US Economic Growth and Innovation

Despite the recession, the venture capital industry is open for business. We have money to invest in innovative promising businesses. We recognize that our industry is one of the only asset classes able to create new jobs at this challenging economic time. According to an IHS Global Insight Study soon to be released, in 2008 venture-backed companies provided 12.05 million jobs and $2.9 trillion in US revenues, corresponding to 10.5% percent of US private sector employment and 20.5% percent of US GDP. From 2006 – 2008 venture-backed companies grew jobs at three times the rate of the private sector overall. Companies that were once small venture-backed businesses include: Google, Genentech, Intel, Cisco, Starbucks, Microsoft and FedEx.

Traditionally, venture capitalists have focused on investments in information technology and life sciences businesses. However, within the last five years, our industry has committed to investing in the highly compelling area of clean technology. In 2008, venture capitalists invested more than $4.6 billion into clean technology businesses that are innovating in the wide ranging areas of alternative energy such as solar, coal gasification, geothermal, and biofuels as well as green building materials, batteries, transportation, and carbon capture and sequestration. Many of these companies have and will be founded on discoveries made through basic, government funded research. I am here today on behalf of those current and future companies.

Venture-backed Small Businesses

These venture-backed companies are quintessential small businesses. Many are pre-revenue and most have fewer than 10 employees. They operate on very tight budgets and must meet designated milestones if they are to receive additional funds. They remain extremely fragile as they face a challenging road fraught with obstacles including regulatory approvals, beta tests, larger competitors, human capital needs, ongoing financing, and ultimately customer acceptance.

It is critical to understand that venture capitalists do not fund basic research projects at our portfolio companies. The venture capital funds our companies receive are specifically directed to building a business around a discovery that has made it through the basic research process and is ready to be commercialized. Yet, these companies may have other early innovations in the pipeline worth pursuing. It is for these *new* projects that these businesses would apply for an SBIR grant, as we venture capitalists can not and will not fund early stage research. Unfortunately today, these companies are forced to make a choice between pursuing SBIR funding for the new project or continuing to access venture capital to bring existing projects to market since the Small Business Administration's (SBA) current interpretation will not allow most venture-backed small businesses to apply for SBIR grants. This scenario has resulted in small businesses at best delaying important discovery projects and at worst, abandoning this important work altogether.

Public/Private Partnerships

In past eras (e.g., the space race or the early days of DARPA), the best and brightest scientists worked in the government and the most exciting innovations emerged from work done by the Federal government. Over time, many of these innovators moved to the private sector and worked for large corporations such as Bell Labs or IBM. Today, some of the best and brightest minds, developing the truly disruptive innovations, are found at small start-up companies. Large corporations simply do not have the internal resources to fund the necessary R&D needed to keep ahead of the innovation curve.

At a time when the national debt is high, government resources are stretched thin, and our need for advancements in clean energy, healthcare, and national security are great, it seems prudent that government agencies would seize the opportunity to work collaboratively with venture capitalists. Only the venture capital industry can make the claim that solutions for which we advocate will truly create a significant number of new jobs through entirely new sectors, reduce our dependence on foreign oil, and help save our environment from the ravages of global climate change. Our track record is clear. In the same way that venture capital helped bring about the high tech revolution and quite literally created the biotech industry, venture-backed entrepreneurs and investors stand ready to meet the challenges that have thus far stymied advancements in solving global climate change.

VCs are continually seeking out the next generation of technology, but the current SBA eligibility rules throw costly, time-consuming, and unnecessary hurdles in the path of government agencies seeking to collaborate with venture capital-backed companies. We believe this is a huge loss for our country. With Congress attempting to reduce greenhouse gas emissions, power our national grid, and transform our vehicles using alternative energy, innovations from the venture capital industry very likely hold the key to resolving the most daunting challenges addressing these complicated issues. The venture industry is poised to meet that challenge and the policies enacted by this Congress, and this Administration will either help or hinder that effort.

Key agencies like the Department of Energy and the EPA have recognized this and have reached out to venture capitalists and our trade association to tout the SBIR program as a mechanism to advance Federal research dollars by backing the most promising companies. We hope that this will be an area in which government policies and the venture industry work together to find solutions for the nation.

Common Misconceptions

With the reauthorization of the SBIR program, Congress has the opportunity to correct a significant injustice that has gone on too long. It has been eight years since an administrative law judge redefined an “individual investor” to mean a “natural person,” thereby opening the door to exclude from the SBIR program small businesses that have received venture capital funding. While there has never been an actual change in law or regulation, the SBA used this interpretation in recent years to deny grants to many of our country’s most worthy small businesses. Under the past Administration, the SBA’s policies regarding SBIR eligibility and how they determined if an entity qualifies as a small business were inconsistent, and based on serious misconceptions which I would like to address.

One of the largest misconceptions is that venture capital firms are equivalent to large corporations, and therefore the companies that they fund should be excluded from consideration from SBIR grants. We agree that large corporate owned businesses should not be allowed to participate in small business programs and have supported past provisions to ensure that this misdirection of small business dollars does not take place. But venture capital firms (and their portfolio companies) are not large corporations with deep pockets and ulterior motives. They are almost entirely private partnerships that are typically comprised of less than two dozen professionals whose sole business is to invest in small emerging growth companies. Venture capital firms focus on the growth of the small business, not to further the agenda of any large corporation. Most often, these small businesses are competing with large enterprises.

Another common mistake is to assume that venture-backed companies are controlled by venture capitalists. While venture capitalists as investors typically take a Board seat, we do not exert day-to-day control of a company for several reasons. The partners at venture firms work with a number of portfolio companies at once. Our time is divided between all investments of the venture fund and it would be impossible and impractical to spend that limited time on the hundreds of nitty-gritty, day-today decisions that the internal management team must make instead of helping the management team make the strategic level decisions necessary to grow. Unlike corporations, venture capital funds are usually limited life entities that make their return on investment only when the portfolio company is sold or makes a public offering of its securities. And lastly, no particular venture capital firm typically has a controlling interest. The 51 percent or more ownership of a company is often achieved because there are several venture firms invested, giving each a smaller, more diluted share in the company. The governance of these companies is most often the result of consensus-building, and the most important voice in the room is that of management, not the investors.

The current policy particularly hurts the regions of our country that the SBIR program was designed to support. The scarce venture capital dollars available in mid-America for instance must cover a greater geographic footprint than in the concentrated areas such as Boston or the San Francisco Bay Area. For this reason, venture funds generally join together to fund a promising start-up, as a single firm indigenous to the region will not have the capital to fund a company fully. As each firm takes an equity stake in the company, the total venture ownership percentage can quickly rise above the 51 percent threshold, thereby making the mid-America start-up company ineligible to apply for an SBIR grant.

SBIR and VC Have Worked Well Together

Throughout the SBIR program's history, majority venture-owned small businesses have applied for and received SBIR funding. This historical precedence strongly suggests that their participation has caused no harm to the program or to other small businesses. To wit, the recent National Academies of Sciences study on the SBIR program offered no evidence that other small businesses have ever been crowded out by the participation of venture-backed businesses.

The NAS report also found that there are useful synergies between venture capital investment and SBIR funding in terms of selecting the most promising companies. During the first two decades of the program, when participation of venture funded firms was not at issue, some of the most successful NIH SBIR award-winning firms were able to perform at high levels because they were allowed to receive venture funding as well as SBIR awards. By excluding venture-backed firms, the SBA removed some of the most worthy applicants from consideration. This clearly should not be the intent of the SBIR program, which seeks to benefit meritorious small businesses.

Conclusion

The SBIR program is a wonderful mechanism for the government and private sector to come together and do what desperately needs to be done to support a strong economic recovery – help small companies to grow and innovate. But the SBA's past policies have seriously negated the positive impact of venture-backed small businesses on innovation. Both venture dollars and SBIR dollars play complementary roles in financing innovation. One is rarely, if ever, a substitute for the other. Venture-backed companies seek SBIR dollars because they are needed to help finance research targeted at innovations that are too early in their development for the venture capitalists to cover. SBA has cut off the innovation pipeline so that many of the most promising projects never see the light of day. It is time for a positive change.

No other asset class supports the premise more that small businesses are the life blood of the US economy than venture capital. As investors in these important entities, we are advocates for their viability and growth. We believe that the best use of government dollars is to leverage public/private partnerships in which we all have a role in bringing innovation out of the garages, labs and tiny businesses into the marketplace, the healthcare system, our military, and renewable energy enterprises. The venture capital community is committed to contributing significantly to this endeavor. We have consistently over the years asked Congress and the Administration to join us. We hope that this year Congress will reauthorize the program with provisions that ensure venture-backed companies have a fair chance to thrive under the SBIR program alongside of their non-venture-backed counterparts. Doing so will strengthen the future success of the program our economy and our nation.

Thank you.